

## Bankia's IPO: Some Remarks on the Biggest Failure in the Spanish Banking System

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**ABSTRACT:** The multiple judicial decisions in favour of those who invested in Bankia's IPO have posed a serious problem for this major Spanish credit institution. This situation has been made even more complicated for the bank by the two judgements recently issued by the Supreme Court, whereby the invalidity of the purchase of shares was acknowledged and the bank was ordered to refund the investments made by the plaintiffs.

**Summary.-** *1. Introduction. 2. Creation of Bankia and its IPO. 3. The avalanche of minority investors' lawsuits against BANKIA. 4. Judgements under appeal and Supreme Court Judgements of February 3<sup>rd</sup>, 2016. 5. Concerns raised by these Judgements of the Supreme Court.*

### **1. Introduction**

BANKIA, the fourth biggest bank in Spain – with assets on the balance sheet of 204m euros (2016) –, has recently experienced some setbacks with its investors

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(e.g.: marketing preferred shares, swaps, etc). Among these setbacks, the failure of its 2011 Initial Public Offering was particularly tough. After thousands of Court Judgements cancelled the acquisition of shares by minority investors, the Spanish Supreme Court ruled twice, establishing case-law, that the stock acquisition by the plaintiffs – small and non-professional investors – in the IPO should be nullified and the Supreme Court ordered the bank to pay back the acquisition price plus interest and legal fees. These two judgements, published on the same day, forced the bank to renounce all the pending court proceedings and offer all minority shareholders the option to buy back their shares, instead.

In the following pages we will explain and analyse critically the main issues posed by these two judgements of the Supreme Court. In order to be more clear, we will start with a brief overview of the creation of BANKIA and its IPO [*infra* nn. 2-3] and the basic ideas noted in the legal judgements above mentioned [*infra* n. 4]. We will then finish with the analysis of the most interesting concerns posed by reiterated court rulings [*infra* n. 5].

## **2. Creation of Bankia and its IPO**

In order to achieve financial aid from the State – through the Fund for Orderly Bank Restructuring (FROB, from its Spanish initials) – and to pass the stress tests established by the European Banking Authority (EBA), seven Spanish savings banks agreed in March 2010 to enter into a cold merger – Institutional Protection System (SIP in Spanish) – whereby they yielded economic and political powers to a new group's joint society.

In July 2010 the SIP underwent the stress tests and the Committee of European Banking Supervisors (CEBS) noted that it would have no problem in any of the analysed scenarios.

In December 2010 the seven savings banks established the SIP's joint society, named *Banco Financiero y de Ahorros, S.A.* (or BFA), and the FROB subscribed 4,465m euros at an interest rate of 7.75% in Contingent Convertible Bonds (CoCos) issued by BFA and guaranteed by the seven savings banks.

Between February and March 2011, facing new requirements in terms of their own resources, the seven saving banks segregated almost all of their assets to integrate them into BFA – *first segregation* –. In April 2011 BFA conducted a *second segregation* of the main part of its assets and liabilities in favour of a small bank owned by one of the saving banks (*Caja de Madrid*), ALTAE BANK, which changed its name to BANKIA. After the latter segregation, only some assets of doubtful value, a small portfolio of securities, the shares in BANKIA – valued at 12,025m euros – and certain fiscal credits corresponding to the accounting cleansing exercise conducted –at 2,744m euros – remained within BFA as assets. The liabilities were, basically, the CoCos subscribed by the FROB. As a result of the *second segregation*, BANKIA increased capital by 12,000m euros and issued 900m shares valued at 2 euros each with an issue premium of 10,200m euros that were completely subscribed by BFA.

In June 2011, BFA decided to offer 55% of BANKIA's shares to the public through an IPO with information about consolidated abridged interim financial statements closed in March 31<sup>st</sup>, 2011. On June 29<sup>th</sup>, 2011, BANKIA registered the IPO prospectus in the Spanish Commission for Securities Markets (*Comisión Nacional del Mercado de Valores* or CNMV). Because it was a newly created company, BANKIA did not provide the annual accounts of the last three years, but just the aforementioned consolidated abridged interim financial statements – first term –and BFA's annual statements. The abridged financial statements were endorsed by Deloitte in a report.

The amount of the capital increase was 1,649m euros with a share premium of 1,443m euros. After this increase, BANKIA's legal capital amounted to 3,465m euros. New shareholders owned 47.6% of the stake and the other 52.4% was controlled by BFA.

The subscription price of the new shares was 3.75 euros per share, which meant that the new stakes were offered with a big discount with respect to the value of those held by BFA in its balance sheet.

Therefore, after the capital increase, BFA reduced its stake in BANKIA to below 70% of the share capital – more specifically to 52.4% – and missed the

opportunity of using the fiscal credit it owned and it had to remove that asset from its balance sheet.

In November 2011, *Banco de Valencia*, controlled by BFA, was bailed out by the FROB due to 18.5% of problematic assets that forced the creation a new provision of 12,000m euros. BANKIA publicly stated that this circumstance did not affect its solvency.

The deadline for BANKIA and BFA to forward the approval of audited financial statements for the fiscal year of 2011 was April 30<sup>th</sup>, 2012 but none of the companies forwarded the information to the CNMV. Not until May 4<sup>th</sup>, 2012 did BANKIA forward the individual and consolidated financial statements to the CNMV, unaudited, reporting a consolidated profit of 305 million euros, *“earnings consistent with those published when the first listing, emphasising the success of the IPO and the strengthened solvency of the Group”*.

On May 7<sup>th</sup>, 2012 BANKIA's chairman, Mr. Rodrigo Rato, a former Spanish Minister of Economy and a former Managing Director of the IMF, stepped down, apparently because the auditor (Deloitte) refused to deliver a clean report because BFA had accounted BANKIA for 12,000m euros when its real market value was around 2,000m euros.

On May 9<sup>th</sup>, 2012 BFA requested that the FROB convert the 4,465m euros of CoCos to shares of BFA, therefore the FROB became the sole shareholder of BFA.

On May 16<sup>th</sup>, 2012 BANKIA forwarded the CNMV the quarterly finance report corresponding to the first quarter of 2012, insisting on the structural stability of the bank. But on May 25<sup>th</sup>, 2012 BANKIA delivered the reformulated financial statements of 2011 and the audit report, where (i) the results had changed from a profit of 309m euros to a loss of 2,979m euros; (ii) the value of the stake of BFA in BANKIA narrowed by 5,189m euros; (iii) the value of the fiscal credits of BFA shortened by 2,713m euros; and (iv) the value of “credit investment” and “foreclosures” of BANKIA went down by 4,168m euros.

On May 26<sup>th</sup>, 2012 BANKIA requested 19,000m euros from the FROB and in September 12<sup>th</sup> 2012 it received 4,500 M € from BFA that BFA had, in turn, received from the FROB.

On June 4<sup>th</sup>, 2012 the Criminal Judge number 4 of the National High Court issued an order allowing the lawsuit filed by a small political party (UPYD) for various offences – including swindling, misappropriation, corporate offences, alteration of prices, etc – against BANKIA, BFA and their managers (*preliminary proceedings 59/2012*).

On December 12<sup>th</sup>, 2012 BANKIA warned that the economic value of the company was -4,148m euros.

In 2013, already controlled by the FROB, BANKIA reduced its capital, downgrading the nominal value of its shares from 2 euros to 0.01 euros. Therefore, shareholders lost almost all the nominal value of their investment, as a previous step to the subsequent capital increase, basically made with public funds, through the FROB.

On February 17<sup>th</sup>, 2016 BANKIA made public its decision to compensate minority shareholders with the whole amount of their initial investment in exchange for the refund of the shares to the bank. If they had sold the shares, they would be paid the difference between what they invested and the loss they got with the sale of the securities. In both cases, the lender compromised to pay out compensatory interests of 1% per annum for the time passed until the restitution of the investment.

### ***3. The avalanche of minority investors' lawsuits against BANKIA.***

After the report of BANKIA's annual statements was reformulated, thousands of small investors proceeded to sue the bank requiring the nullity of their acquisition due to the faulty information received. Thus, by December 31<sup>st</sup>, 2014, BANKIA had received 933 claims for this reason, whereas by December 31<sup>st</sup>, 2015, private investors' lawsuits amounted to 76,564.

By December 31<sup>st</sup>, 2015 courts had delivered 24,029 judgements that obliged BANKIA to pay back 820m euros. There are no statistics regarding the success of the plaintiffs, but it is clear that there is a high percentage of suits against BANKIA --around 95%-- that have been successful in the Courts, which, so far, has implied that the lender had to pay a complementary amount of about 500m euros due to attorneys' fees, legal costs and interests.

Once the two judgements of the Supreme Court were published, and given that minority investors acquired 1,855m euros of stocks in the IPO, BANKIA publicly renounced the continuation of its defence in court. On February 17<sup>th</sup>, 2016, the company offered publicly to compensate its minority investors with the whole amount of their initial investment in exchange for the return of the stocks, plus a compensation of annual interests of 1% for the time passed until the refund of the investment. BANKIA has provided 1,840m euros to fulfil this commitment.

#### ***4. Judgements under appeal and Supreme Court Judgements of February 3<sup>rd</sup> 2016***

Among the several judgements of the Provincial Courts ordering BANKIA to repay the price paid for the stocks in the IPO, two of them were appealed to the Supreme Court. The *first* sentence that BANKIA appealed was that of Valencia Provincial Court, section 9<sup>th</sup>, of January 7, 2015<sup>2</sup>. This judgement declared the nullity of subscription shares in BANKIA that were undertaken by some individuals "*following the advice of the employees of the firm*", amounting to 20,868 euros. The ultimate reason that justified the decision was that, whereas in the information prospectus there was an announced profit of 309m euros, in the final accounts of the fiscal year ending in 2011 the lender reported a real and effective loss of 3.030m euros.

The *second* decision that BANKIA appealed was the judgement of Oviedo Provincial Court, section 5<sup>th</sup>, May 11<sup>th</sup>, 2015<sup>3</sup>. The ruling also declared the nullity of subscription shares in BANKIA amounting to 9,997.50 euros undertaken by a couple, a driver and a retired teacher, "*following the advice of an employee of the company*". Once again, the ultimate reason that justified the decision was

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<sup>2</sup> ECLI:ES:APV:2015:1

<sup>3</sup> ECLI:ES:APO:2015:1222

the mismatch between the data of the prospectus and the results reported by the lender in the accounts of the fiscal year 2011.

As we said, BANKIA filed an appeal before the Supreme Court against these sentences from the Valencia and Oviedo Provincial Courts. Both were resolved through the ruling of the full Chamber of the Supreme Court on February 3<sup>rd</sup>, 2016.

In the first of these said sentences of the Supreme Court (STS 23/2016), reporting judge Mr. Pedro J. Vela<sup>4</sup> examined the reasons alleged by BANKIA.

BANKIA claimed that the appealed judgement had presumed the lack of truthfulness in the IPO prospectus without the existence of direct evidence proving misrepresentation. The Supreme Court refused that argument, arguing that the Provincial Court did not use presumptions as evidence, but had considered a notorious fact as proven, instead: that after publishing the brochure, BANKIA had reformulated its annual statements *“with a result completely the opposite to what was advertised in the prospectus, given that instead of profits there were major losses”*.

BANKIA pleaded as well that there was no causal link between the mistake and the conclusion of the subscribing contract of its shares. With regard to this, the Supreme Court stated that for error to invalidate consent (art. 1266 Spanish Civil Code), the following aspects should apply: (a) it must be about the substance of the thing that constituted the subject matter of the contract, or about the conditions thereof that should have been the main reason to enter into it; (b) that the mistake may not be attributable to whomever suffers it; (c) that there exists a causal link between the error and the aim intended in the legal transaction concluded; and (d) that the mistake could not be avoided by the person who suffered it by using reasonable diligence.

The Supreme Court dismissed the latter allegation of BANKIA since the Provincial Court judgement did establish properly the link between the acquisition of the shares and the content of the prospectus that, a few months

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<sup>4</sup> ECLI:ES:TS:2016:91

after, was proven wrong when relevant losses materialized in the reformulated annual statements.

In the second of the judgements of the Supreme Court, reporting judge Mr. Rafael Saraza (STS 24/2016), examined four arguments posed by BANKIA.

Firstly, BANKIA claimed that the fact that the falsehood of the annual statements was under criminal investigation (*preliminary proceedings 59/2012*) prevented the civil judges from being able to examine the case. The Supreme Court refused this argument since in the *“civil process there is no discussion on whether the managers of BANKIA incurred in criminal behaviour of distortion of the data included in the prospectus, but if this data, because of its inaccuracy, provoked the error defect of the complainants”*. Moreover, as the Supreme Court notes, it would be very inefficient for any claim of the investors for the defects in the information provided if *“it was necessary to wait until the completion by final judgement of the criminal case that could be followed against the managers of the company due to falsehood in the annual statements or other documents that should reflect the legal or economic status of the lender”*.

The *second* and the *third* arguments of BANKIA, also concerning issues of procedure, focused on refuting that the inaccuracy of the financial information provided in the prospectus constituted a notorious fact. The lender also rejected the inappropriate use of the judicial presumptions. However, the Supreme Court rejected both arguments with very similar points to the ones exposed in its previous decision.

Similarly, the last argument for the appeal focused, as in the prior case, in denying the existence of a causal link between the error and the subscription of the shares. That was so, the company stated, because the complainants had not read the prospectus of BANKIA’s IPO and therefore *“the lack of truthfulness in the prospectus could not be considered as the cause of the submission of the consent of the complainants”*.

The Supreme Court quashed this argument considering it *“obvious that if the complainants had not incurred such an error about the economic situation of*



*BANKIA, they would not have consented in acquiring the shares*". The Court also deemed it irrelevant whether the complainants had read the brochure or not, since *"the information spread through the publication of that prospectus and the comments that it would have aroused in different spheres would have deterred small investors such as the complainants from investing"* given that *"they do not have any stake other than the economic yield from collecting and profit sharing by the company and the share appreciation, and that they have no way to obtain the information other than the IPO prospectus, in contrast with what may happen with large investors"*.

## **5. Concerns raised by these Judgements of the Supreme Court**

The two decisions of the Supreme Court raise the following concerns:

### **5.1. If they had been professional investors... would the judgements have come to the same conclusion?**

The STS 23/2016 rightly says that the information provided in the IPO prospectus is essential for small investors. This is so even if they have not read it since its release triggers the dissemination of information *"that produces the willingness to invest"*. The STS 24/2016 insists upon this idea by holding that the release of the brochure is not imposed in order that all the investors consult it, but in order that it may be screened *"by those who create opinion in economic topics so that the information arrives, through different ways, to those potential investors who lack other means to get informed"*<sup>5</sup>.

The Supreme Court also notices that large, professional or institutional investors, unlike small investors, *"may have access to other kinds of complementary information"*, in addition to what is offered in the prospectus.

Some commentators wanted to draw from this comparison that the judgement did not apply to those who were not small investors. In their opinion, all

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<sup>5</sup> This idea was advanced by the authors who analysed the so called "*transparency culture*". See Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Virginia Law Review, 1984, 717-753, 723-725; and, in Spain, Farrando, El concepto de "valor negociable" y la aplicación en España de la cultura de la transparencia, Iglesias Prada (coord.), *Estudios Jurídicos en homenaje al profesor Aurelio Menéndez*, Madrid, 1996, 1197-1236, 1210-1212.

investors who may be classified as professional or institutional would be excluded from its operation.

Nevertheless, that conclusion seems wrong to me. This is so because the decisions of the Supreme Court do not exclude non-minority investors from the protection of the prospectus at any stage. The Court just limits itself to note that professional investors, given their special nature, could have complementary information that, where relevant, could lead to the conclusion that in the acquisition of the shares the said error did not constitute a defect of consent. In other words, a sensible understanding of those statements is that the Supreme Court only wanted to reinforce its argument about the error in the consent of these private individuals that acquired shares in BANKIA, advised by the employees of the lender. In no case is it stated that institutional investors could not have incurred the same error, but that in the context of this sort of investors it “*could*” be the case that they had other information that would have allowed them to avoid it (for example: because they have a seat in the BANKIA’s Board of Directors, etc).

This seems to be the understanding of a judgement of the Court of First Instance number 98 of Madrid<sup>6</sup>, which very recently sentenced BANKIA to pay back 2 million euros to a Spanish watch company because the information provided in the IPO prospectus was “*inaccurate and incorrect*” and that company did not have supplementary information that unveiled the error.

If this reading strengthens, BANKIA could face additional losses of up to 600m euros more, since half of the 1,200m euros of the shares subscribed by these kind of investors were sold without losses few days after the company went public.

## **5.2. However, was there inadequate commercialization of the shares in BANKIA?**

In the two analysed cases, it is accepted that the purchasers of the shares were investors classified as minority investors, and that either they had not

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<sup>6</sup> judgement 176/2016, April 29<sup>th</sup>, 2016, of the Madrid Court of First Instance number 98 [ECLI:ES:JPI:2016:96].

conducted the suitability test of the client or, when they did it, they had a poor outcome (article 79 bis.6 LMV and art. 19.4 Directive 2004/39/CE). It is also explicitly stated in both judgements that those affected did not conduct a simple order to buy shares in BANKIA as a result of reflections of their own, but instead, they, in reality, adopted the decision “*advised*” by employees of BANKIA<sup>7</sup>.

Nonetheless, the Supreme Court decided not to determine the cases by means of that non-compliance of the obligations of BANKIA – mis-selling –, which would clearly exclude all professional investors, but by the most expansive means of shortage of information in the prospectus as the reason that caused the nullity of the contract by mistake of consent of the investors.

**5.3. Is it possible to request the nullity of the underwriting of the shares (art. 1266 CCiv) instead of turning to the liability for damages and impairments prescribed by the rules that regulate the prospectus (art. 28.3 LMV<sup>8</sup> and art. 6 Directive 2003/71 CE)?**

The Supreme Court decisions consider that, under the dispositive principle, the specific convictions foreseen in the regulation of the securities exchange (article 28.2 LMV<sup>9</sup>) are compatible with the nullity of actions due to a mistake in the consent (article 1266 CC), therefore allowing investors to choose the legal protection they considered most appropriate.

BANKIA also pleaded that declaring the nullity of the underwriting of the shares due to a mistake in the consent of the purchasers of their shares would in fact

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<sup>7</sup> Therefore, it seems that the employees of BANKIA made “*customised recommendations*” to its clients because they talked to them as a investors, or potential investors, and recommended the investment as suitable for them --under the words of the judgement of the Court UE, fourth Chamber, May 30, 2013 (*Genil 48, S.L. et al*), n. 52 [ECLI: EU:C:2013:344].

<sup>8</sup> *Ley 24/1988, de 28 de Julio, del Mercado de Valores* (Act 24/1988, of 28 July, on the Securities Market), or LMV.

<sup>9</sup> Article 28.3 LMV: “*In accordance with the conditions laid down by regulation, any of the persons indicated in the previous sections shall be liable for any damages that may be caused to the owners of the securities acquired as a result of false information or omissions of relevant data from the prospectus or any other document that the guarantor must draw up*” [currently: article 38.3 of the new *Real Decreto Legislativo 4/2015, de 23 de octubre, por el que se aprueba el texto refundido de la Ley del Mercado de Valores* (= *Spanish Royal Legislative Decree 4/2015, of October 23, approving the revised text of the Stock Market Law*)].

invalidate the share capital increase. And, if that happened, it went on, the rules on the nullity of the company and, in particular, the ones related to the limitation of the causes of nullity in the company (art. 56 LSC and art. 10 First Directive 68/151/CEE) should apply. In its opinion, that would eventually forbid the recognition of the lack of information as the cause of the nullity of the shares.

The Supreme Court did not accept that reasoning, relying on the EU Court judgement of December 19<sup>th</sup>, 2013 (*Hirrmann/Immofinanz*) [C-174/12]. And acknowledging that the plaintiff shareholder of a faulty prospectus has to be considered as a third party, since his or her pretension does not have *causa societatis*, nothing prevents the company from being ordered to pay back the equity contributions. If this is so, it follows, a door opens to the purchasers of those stocks to claim civil liability for the inaccuracy of the brochure or, if the aforementioned requirements are met, demand the nullity of the contract by the defect of consent with *ex tunc* effects (arts. 1300<sup>10</sup> y 1303<sup>11</sup> CCiv).

#### **5.4. What about the liability of the surveillance authorities –CNMV and the Banco de España (BdE)—and the auditors?**

Some investors affected opted for filling a lawsuit against the CNMV, BdE and the Ministry of Economy and Competitiveness. They demanded compensation for the losses suffered due to the malfunctioning of those agencies and public financial surveillance services that, from their point of view, allowed BANKIA to draw up an IPO with a defective prospectus.

The National High Court recently refused pecuniary liability of the Administration, considering that *“the absolute guarantee that there will not be malfunctions in the various systems cannot be demanded, and the mere existence of those organisms [...like the CNMV or the BdE...] does not constitute, by itself, title of imputation enough to claim pecuniary liability with the aim of*

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<sup>10</sup> Article 1300 of the Spanish Civil Code says *“Contracts which meet the requirements expressed in article 1261 [...article 1261 CC: There is no contract unless the following requirements are present: 1. Consent of the contracting parties. 2. A certain object which is the subject matter of the agreement. 3. Cause of the obligation established...] may be annulled, even if there is no injury to the contracting parties, provided that they suffer from any defects which invalidate them in accordance with the law”*.

<sup>11</sup> Article 1303 of the Spanish Civil Code says *“Upon a obligation’s being declared null and void, the contracting parties must reciprocally return to one another the things which constituted the subject matter of the contract, with their fruits, and the price, with interest (...)”*.

*compensating any damage that may occur by the voluntary engagement of the citizens in the financial sphere, regardless of the reason that had caused it*<sup>12</sup>. The court eventually reminds us that, as it has already decided in other cases mentioning the recitals of the Directive 1997/9/CE, that *“no surveillance system may offer full warranty, particularly in the event that fraudulent acts are committed”*<sup>13</sup>.

Subsequent lawsuits of other investors also directed against the CNMV, BdE and the Ministry of Economy and Competitiveness based on an allegedly negligent action of the BdE and the supervision of the initial listing of BANKIA had the same fate<sup>14</sup>.

Recently, the number 4 Criminal Judge of the National High Court that is analysing the criminal lawsuit against BANKIA (*preliminary proceedings 59/2012*) extended the probe against the auditor of BANKIA (Deloitte and the audit partner) due to their intervention in the statements used for the IPO.

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<sup>12</sup> See judgement of the Spanish National High Court 256/2015, 5<sup>th</sup> section, September 23<sup>rd</sup>, 2015, (*Bankia*) [ECLI:ES:AN:2015:3320].

<sup>13</sup> See judgement of the Spanish National High Court, 3<sup>rd</sup> section, February 10<sup>th</sup>, 2010 (*Forum Filatélico y Afinsa*) [ECLI:ES:AN:2010:627] [ECLI:ES:AN:2010:631 y ECLI:ES:AN:2010:634].

<sup>14</sup> Thus, the judgement of the Spanish National High Court 345/2015, 5<sup>th</sup> section, October 21<sup>st</sup>, 2015 (*Bankia*) [ECLI:ES:AN:2015:3917] also ends up refusing the liability action against these agencies due to the fact that the losses are out of the control and the functions of the BdE, given that it is a stock exchange operation, decided by the investor.